

COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF PUBLIC UTILITIES

DPU 96-100
ELECTRIC INDUSTRY RESTRUCTURING NOI/RULEMAKING

COMMENTS OF THE CONSERVATION LAW FOUNDATION
ON THE DEPARTMENT'S MAY 1, 1996 PROPOSED RULES

I. Introduction

_____CLF appreciates the opportunity to comment on the Department's Proposed Rules for restructuring the Commonwealth's electric industry. CLF believes that the Proposed Rules set the right general direction and will hasten the necessary transition to a truly competitive industry.

In particular, CLF commends the Department for affirming the importance of assuring environmental quality during and after the transition to competitive markets. The Proposed Rules appropriately provide for appropriate targeted incentives, where needed, for energy efficiency and renewable/low emissions generation. The Commission's explanatory statement also appropriately supports the concept of environmental comparability between incumbent generation and new competitive entrants. Implemented properly, the Department's proposed treatment of environmental quality in restructuring can be the leading model for the nation.¹

¹ In response to a request by CLF, the Executive Office of Environment Affairs notified CLF and the Department by letter dated June 23, 1995 that review of the Department's electric industry restructuring initiatives may be appropriate under the Massachusetts Environmental Policy Act (MEPA), G.L. c.30 sec. 61 et seq. (A copy of the letter is attached to these Comments).

At the same time, CLF is concerned that the Proposed Rules do not sufficiently outline a quick transition to real generation competition. CLF is especially concerned about proposed options which would allow for, or require, ongoing contracts between distribution companies and generating units; which retain modified monopoly regulation over nuclear units; and which provide opportunities for continued protection of existing generation units through regulatory mechanisms for stranded investment recovery and basic service.

Section II of CLF's Comments restates the environmental urgency of moving towards competition quickly, on a level environmental playing field. Section III of CLF's Comments addresses issues of market structure and regulation addressed in the rules which are not specifically environmental, but may have environmental consequences. Section IV of CLF's Comments addresses three specific environmental issues: environmental comparability for generating units; energy efficiency; and renewable/low emissions energy resources.

II. The Importance of Moving Quickly to Generation Competition

The most important short-medium term environmental gains for

EOEA noted, however, that MEPA review was "premature" at that time until a more "definitive" proposal was developed. CLF believes that the Department's proposed Rules are arguably still not sufficiently definitive with respect to key environmental provisions (e.g. environmental comparability) to trigger and facilitate MEPA review. Accordingly, CLF does not request MEPA review at this time, but reserves the right to do so when the Department's proposals become more definitive during these proceedings, up and to and including issuance of Final Rules.

the Commonwealth's and New England's air quality and water quality will come from retirement and replacement of much of the region's existing fossil-fueled generating stock.² That stock of pre-1970 coal and oil plants operates under environmental regulations significantly less stringent than those faced by new plants that would be built today -- less stringent in some cases by an order of magnitude.

Significant turnover of that stock will require new investment in cleaner resources, whether they be new fossil fuel plants or renewable energy projects. And new investment will require, at minimum, a new market structure with real customers willing and able to commit to purchases. But the historic regulatory "promise to pay" utilities for their investment is effectively dead. The only new markets which have a prospect of vitality to coax new investment are ultimate customer (i.e. direct access) markets -- which do not yet exist. The longer the transition to direct access is delayed, and existing generation is protected from competition, the longer the existing, dirty generating stock will remain in place.

This is not to say that direct access and de-subsidization of existing generation is a panacea for the environment. Far from it. A significant number of existing dirty units, even when removed from regulatory protection, are likely to be economically attractive in direct access for an unacceptably long period of

² Energy efficiency and renewables are also critical to the medium-long run environmental sustainability of the region, especially with regard to such pollutants as carbon dioxide.

time absent environmental comparability policies. Moreover, turnover of the existing stock will not stabilize CO2 emissions; these can only be addressed through conservation, and net zero emission renewable resources.

But there is not even the possibility of new, cleaner investment to challenge the existing stock without a viable customer payment stream to support that new investment, and a strong set of rules that removes all regulatory subsidy from existing generation. There is simply no way out of the present environmental purgatory between planning and markets except to move toward markets, circumscribed by appropriate environmental requirements and clean technology incentives.

Accordingly, CLF strongly urges the Department to resolve the questions posed in its May 1 proposal in favor of options which as rapidly as possible remove barriers to new, clean generation investment. At a minimum, this means a rapid transition to direct access; the swift removal of all remaining regulatory protection of existing generation; and the establishment of appropriate environmental comparability requirements. No doubt, a rapid transition will not be perfect. But delay, and lingering regulatory protection for generation, is a far worse alternative. The time to move decisively is now.

III. Removal of Barriers to New, Cleaner Investment

In a number of areas, the Department has the opportunity to expose existing generating units to robust competition by taking the right steps on market structure, or, conversely, to shield

those units from competition in a way that could artificially prolong their lives. Key areas are discussed in this section.

A. Ongoing Distribution Company Role in Generation

At a number of points in the explanatory statement, the Department appears to contemplate a potentially significant "power purchasing" role for disaggregated distribution companies to provide "basic service." While this role appears to be primarily as a "pass through" of PE power, the Department also contemplates going beyond such a role at several points:

- "competitive bidding for short-term wholesale contracts" (footnote on page 45);
- "One option for preventing anti-competitive transactions among affiliates would be to require the distribution entities of those electric companies that choose not to divest of generation assets to purchase power from the PE or, after a robust generation market has been established, from non-affiliated sources of generation." (page 27)
- "One way to avoid this potential outcome might be to require contracts for power generated from divested plants with the distribution affiliate that sold the generating assets. The contract period would coincide with the period for recovery of stranded costs. . ." (page 56).

CLF strongly urges the Department to reject these options, as they could effectively "lock up" market segments from true competition with publicly regulated contracts. The cleanest and most robust path towards competition lies in removing the distribution company from power purchases altogether. Where the Department seeks to buffer customers from the possibility of bad "market outcomes," this should be accomplished through direct financial arrangements that do not affect generation purchase obligations.

B. Nuclear Generation Re-regulation

The Department contemplates potentially retaining nuclear units under some form of economic regulation, in several of the questions posed on page 59. CLF believes that there is no justification for such special treatment. Nuclear units should survive or fail on their own marginal costs like all other generation.

Indeed, to ensure that nuclear unit owners have rational economic incentives to retire units when they no longer meet a market test, and not a perverse incentive to operate those units simply to delay the incursion of nuclear decommissioning costs, the final rule should provide for recovery of all fixed decommissioning costs which are independent of further plant operation in the general access charge. This approach will decouple the decommissioning issue from the economic operating issue, and not artificially delay access to market space by competitive entrants based on artifacts of nuclear decommissioning-related accounting rules.

To the extent that continued safe operation of otherwise economic nuclear plants is an issue -- and CLF believes it is a quite valid one given recent operational history of several New England nuclear units -- that issue must be addressed directly through the appropriate nuclear safety regulation channels. CLF urges the Department to engage nuclear safety regulators directly, in coordination with the other New England states, to ensure that these regulatory functions are carried out

aggressively during and after the transition to competition. Otherwise uneconomic nuclear plants should not be protected from competition in order to compensate for the failure of nuclear safety regulation; that is unlikely to help the safety situation, and will simply entrench further a potentially quite costly segment of New England generation.

C. Stranded Investment True-Ups Vs. "Flash Cuts"

The Department's potential ongoing "true-ups" of stranded investment at page 62-62 pose, in CLF's view, a significant risk of insulating existing generation from the normal risks of market operation of such units. By trying to constrain upside and downside risk associated with those units, the incentive for companies to take a hard look at actual costs to operate those units are blunted. CLF strongly prefers a sharper transition which requires generation owners to bet only with their own money, and not the anticipation of a future revenue stream from the difference between a retained unit's costs and market costs.

D. DPU Oversight of Generation Divestiture

Likewise, the Department appears to contemplate a significant regulatory role overseeing divestiture of generating assets (page 56 - 57). This could also lead to less than optimal market functioning during what may be a long transition period. If the Department's goal is to attempt to ensure that divestiture happens at the optimal time for each asset, that time may not occur until the distant future.

An alternative and cleaner approach that merits exploration

is to create an incentive for timely divestiture by providing a lower rate of return on stranded embedded generation costs and allowing the divesting company to share a modest percentage -- say, 10% -- of the reduction in stranded investment recovery that results from such divestiture.

E. The Independent System Operator

CLF generally agrees with the statement's discussion of the importance of a truly independent system operator ("ISO") to operate the transmission system in New England in accordance with NERC/NPCC reliability standards. In CLF's view, to the extent technically and politically feasible:

- The ISO should have no financial interest in any entity involved in the generation or distribution of electric service or the equipment used to provide those services or related energy services.

- The ISO should have no financial interest in companies that consume substantial amounts of electricity.

- The ISO should not take title to any quantity of electricity for resale.

- The scope of the ISO's authority should be limited to the grid system - the assets necessary for the operation of the common network.

- The ISO's monopoly control should be limited to those assets that are necessary for "network" operations, are expensive to duplicate and require comparable access and terms of use.

- Generation assets "in support of transmission" should not

be part of the transmission monopoly. Rather, the quantity, quality and location of generation assets used in grid operations must be seen by the ISO as a cost to be minimized consistent with reliability. The ISO must be free to contract for these assets whether from generation capacity or interruptible load in a manner that minimizes costs. In fact, a vigorous arms length market in "ancillary services" is critical to the efficient, and fair operation of the wholesale market. Policing the market power by generators in the supply of ancillary services will be one of the principle on-going regulatory issues.

- The ISO's purview should be limited to operation of the grid system. The ISO should not be a market maker.

CLF believes that in addition to its structure, a critical aspect of the ISO is its governance. Particular activities that must be accomplished, most likely regionally, include:

- Oversee the process for hiring, dismissing and compensating the ISO. This would include development, and adjustment as necessary on an ongoing basis, of the incentive regulation of the ISO, and resolution of related complaints. If these decisions are made primarily by entities with affiliated generation, particularly those with greatest load or resources, the independence of the ISO will be compromised.

- Establish a process for all stakeholders to provide input into the development, and adjustment on an ongoing basis, of operating procedures.

- Establish a process for alternative dispute resolution

related to operating procedures to speed decisions, and lower threshold complaint costs.

F. The Power Exchange

CLF also agrees with many of the DPU's suggestions with regards to a power exchange. As set forth above, CLF believes the ISO should not have a merchant function. Thus, CLF favors a complete separation between an ISO and market participants, including a power exchange, and consistent application of ISO rules to all market participants including a power exchange.

CLF also agrees that mechanisms are necessary to prevent abuse of market power by distribution companies with affiliated suppliers. In fact, as stated previously, CLF does not believe that distribution companies should have an ongoing power purchasing role. CLF has not examined whether a requirement to conduct business through a power exchange is the best mechanism to prevent abuse where there is a concern regarding affiliate suppliers of a distribution company. As a general matter, CLF tends to favor a voluntary exchange or exchanges to minimize opportunities to build uneconomic requirements, or procedures into an exchange.

Finally, CLF notes that visible accurate spot prices will be important to a well functioning electricity market. CLF has not determined what the best method would be to assure accurate visible spot prices.

G. Distribution Company Regulation

At page 42, the Department has posed many important

questions regarding the optimal regulation of the distribution company to ensure least cost distribution investment and operation. However, CLF believes it may be too early to answer them, although CLF believes that distributed generation and targeted demand side are likely to provide important least cost opportunities (see section on DSM). Some time will probably be necessary to observe and evaluate the behavior of disaggregated distribution companies before appropriate incentive regulation and distributed generation ownership rules can be devised. CLF recommends that a two year period after disaggregation would be appropriate to allow for such observation and evaluation.

In the interim, to ensure fair competition for distributed resources also, CLF believes that the Department's requirements for power buy-back and non discriminatory interconnection standards and rules for the distribution company should be implemented immediately. Such requirements benefit not only distributed renewable resources but also other distributed technologies such as cogeneration and fuel cells. They are necessary to level the playing field between distributed and central resources.

H. Antitrust Immunity

_____The Department appropriately revisits the "state action" exemption from the antitrust laws now in place for much of the regulated monopoly structure. However, the proposed language of 220 CMR 11.06(3)(i) may not accomplish this purpose. By disavowing any purpose to "impair" the antitrust laws, the

Department might be construed to have left existing immunities (which are part of antitrust case law) intact. A more appropriate wording might be, "Notwithstanding any provisions of these rules, no conduct between distribution companies and generation affiliates shall be deemed to be immune from the antitrust laws under the state action doctrine."

IV. Environmental Comparability, Energy Efficiency, and Renewable/Low Emissions Technology Commercialization

CLF commends the Department for its strong support of key environmental concepts in its explanatory statement and Proposed Rules. Implemented properly, the Department's approach will result in the best combination of market forces and light-handed regulation to ensure that environmental quality is enhanced through restructuring.

A. Environmental Comparability

CLF strongly endorses the adoption of policies to ensure that, as part of industry restructuring, existing electric generation is required to meet environmental standards comparable to that faced by new generation. As CLF has noted in its previous comments in the Department's predecessor docket, environmental comparability is appropriate both for obvious environmental reasons (that air and water quality does not worsen as a result of restructuring), and for competitive reasons (that incumbent generation players do not retain an undue environmental subsidy that effectively locks new generation entrants out).

CLF believes that such a policy is well within the Department's existing organic authority to ensure reasonable

rates; retarding a truly competitive market through environmental preferences for existing generation will not ensure robust competition and its economic benefits. In addition, the Department has an affirmative duty under M.G.L. c. 30, sec. 61, to ensure that, as part of its rulemaking process, it has taken all feasible means and measures to eliminate potential negative impacts on the environment from greater generation competition. Indeed, the Commonwealth, joining other Northeastern states has recently argued that the Department's federal counterpart, the Federal Energy Regulatory Commission, has a parallel duty to mitigate potential environmental harms from increased generation competition. See attached "Joint Resolution of the Committee of the Environment of the Conference of the New England Governors and Eastern Canadian Premiers."

Although the Department has sufficient legal authority on its own to impose such environmental comparability requirements, CLF believes it may well be appropriate for the Department and its sister agency, the Department of Environmental Protection, to immediately commence parallel and coordinated rulemakings to establish the content and timing of those requirements. This coordinated, dual-track approach will ensure that the DEP's extensive expertise in utility emissions control is utilized in the process and at the same time woven into the economic fabric of industry restructuring, which is the Department's primary responsibility.

CLF has proposed in several fora that the triggering event

for environmental comparability standards be the introduction of direct access and stranded investment recovery rather than an interval after a plant's "original retirement date," as suggested at p. 39 of the Department's statement. That is because the source of concern is the potential market pressure in a direct access environment to otherwise operate very dirty and cheap units, not the passing of the retirement date itself. In addition, CLF has proposed that some phasing of the requirements be allowed to enable plant operators to plan and implement such emissions reductions. These issues should be examined in the suggested parallel and coordinated rulemaking.

CLF's initial analysis to date has suggested that the immediate imposition of aggressive environmental comparability standards, if appropriate emissions trading and offsets are allowed, would raise projected operating costs of typical Northeastern coal- and oil-fired units by, at most, several mills per kilowatt hour. While having only a modest to undetectable impact on regional electricity prices, environmental comparability standards could result in the replacement or substantial clean-up of a significant fraction of New England generation.

Quite apart from the regional environmental and economic benefits of such an approach, Massachusetts and other New England states can capture important high ground in discussions and potential litigation with upwind regions, such as the present FERC Open Access EIS debate and the Ozone Transport Assessment

Group discussions. Having mitigated potential environmental harms from open access in New England, the region can rightly argue that upwind states in the Midwest and Mid-Atlantic region should take similar steps as their generation enters an open access environment locally and at the national level.

B. Renewables

CLF strongly supports renewables commercialization support as provided for in the proposed rule. We have several specific recommendations for refinements as follow:

- Fuel cells should be eligible for commercialization support. Fuel cells are critical to eventual transition of our energy economy to one based on hydrogen produced by renewables, where they will provide the power conversion element of such renewable power systems. Fuel cells also provide an immediate opportunity to generate power with essentially no pollution emissions beyond carbon dioxide and could thus greatly facilitate reducing power system air emissions to environmentally sustainable levels (fuel cell emissions are sufficiently low that they have been recently exempted from air licensing by the Massachusetts DEP). For these reasons, fuel cells should be included as a technology. This could be accomplished by adding language to Section 11.08(2) as proposed below:

"Renewable Energy Resources shall mean those resources whose common characteristic is that they are non-depletable or are naturally replenishable but flow limited and fuel cells."

- Flexibility in use of the renewables fund. CLF believes that to commercialize appropriate renewables that will benefit

Massachusetts consumers, a wide range of barriers exist beyond buying down the cost of renewables projects and that removing these "non-cost" barriers is critical to commercialization. Examples of activities that could help remove non-cost barriers would include: support for renewables project siting reform, engineering feasibility studies for unconventional applications, under-writing performance risk of unconventional technology applications, etc. CLF thus recommends that the Department should be given broad flexibility to decide how monies collected by the Renewables Fund are applied. Recommended revisions to the proposed rule to accomplish this are as follow:

"Funding of Renewables. A charge shall be established to support the Renewables Fund. This charge shall be part of the General Access Charge collected by the Distribution Company. Monies from the renewables fund shall be distributed to ~~Renewable Energy Resource providers~~ support renewables commercialization in a manner to be determined by the Department.

- CLF supports the inclusion of buy-back requirements for small renewable projects. We note that considerable detailed attention to specific implementation of this provision in context of the evolving complexity of small customer bill dis-aggregation and multiple service providers will be necessary for this provision to be practically implemented.
- Support for distributed renewables projects. CLF believes that the Department should ensure that Distribution Company regulation will effectively persuade such companies to invest in both geographically targeted DSM and distributed clean generation where such investments will lower the cost of providing

distribution services. The resulting potential financial support for certain distributed renewables projects would compliment direct project support through the Renewables Fund.

C. DSM

CLF strongly supports the proposed energy efficiency investment requirements presented in the Proposed Rules. In addition, we have several specific recommendations for refinements as follows:

- The need for continued regulated utility energy efficiency investment.

CLF strongly supports the Department's rationale for the continued involvement of distribution companies in providing energy efficiency services. CLF agrees that market barriers to economic energy efficiency investment will continue to exist, even as competition may increase the availability and reliance upon energy efficiency investment driven solely by market forces. As the Department notes in its investigation, these barriers take numerous forms and are likely to persist for many years.

CLF also sees at least two additional important reasons for continuing to mandate distribution company DSM investment:

a. Climate change.

As described in a recent report of the Boston Edison Settlement Board Research Fund, the greatest potential for power system emissions to produce adverse economic impacts is through a range of impacts that may well result from greenhouse gas

emissions-induced climate change. As further noted in this report, energy efficiency is a key element of any foreseeable "least-cost" strategy to reduce regional greenhouse gas emissions to climate stabilization levels. The long-term economic benefits to Massachusetts from continued utility investment in improving energy efficiency could thus be enormous.

b. Responding to unanticipated future events.

Many critics of utility mandated energy efficiency investment in recent years have cited New England's substantial excess capacity (on paper) as a major rationale for reducing DSM investment levels. Energy efficiency proponents have responded that simply maintaining the capability to aggressively ramp-up energy efficiency investment - if warranted at some future time - has considerable value even if we cannot accurately predict the nature or likelihood of such conditions. CLF would note that we have been testifying before the Department and in other states for some time that given the composition of the New England power system, the potential exists for emergency conditions to develop that could be mitigated by ramping up DSM or that would otherwise be much more severe if reasonable levels of energy efficiency investment had not been taking place. CLF needs only point to conditions in Connecticut and possibly throughout NEPOOL this summer that clearly would be much worse absent energy efficiency investment that has occurred over recent years to illustrate this point. Depending on what actually happened this summer and the future fate of several of the region's nuclear units, we may well

find that dramatically increased energy efficiency investment may be a critical element of any permanent solution to the problems creating this summer's emergency conditions. Massachusetts is fortunate that its utilities have maintained the capability to deliver energy efficiency, which in turn means that we do not face the several year time lag that was required in the late 1980's to develop and ramp-up a capability to deliver large savings volume.

- Shift energy efficiency investment focus to market-driven programs and market-transformation.

CLF fully supports the Department's proposal that distribution company energy efficiency investment shift over time towards market-driven programs and that market-transformation investment be pursued to the maximum extent practical.

- Utility incentives.
 - a. Energy efficiency investment cost recovery.

CLF believes it is premature to define appropriate distribution company energy efficiency investment cost recovery, including whether associated incentive treatment may be necessary to facilitate quality energy efficiency investment.

CLF also believes that while savings resulting from market-transformation program investments may not be measurable to the accuracy possible for "traditional" DSM programs, savings resulting from such programs can and should be measured at an appropriate level of accuracy and that such savings measurements may potentially have an important role in measuring program

success and influencing cost recovery.

b. Price cap regulation.

Price cap regulation as proposed for distribution companies could create dis-incentives to energy efficiency investment. Revenue cap treatment would not create such dis-incentives. If price cap regulation is adopted, the need for incentive treatment as an element of energy efficiency cost recovery would be substantially increased.

- Future budget levels.

CLF believes it is premature to propose specific program budgets for the full proposed five year planning period. It would be appropriate for these plans to provide a general sense of direction for energy efficiency program activities, describe the planning process to be used to identify and plan market transformation activities and to provide traditional program and budget detail for a two year period. The Department should note that many opportunities exist and will emerge for distribution companies to expand their market transformation activities, many of which have not yet been identified or well characterized. Thus it will be difficult to accurately project investment levels very far into the future.

- Energy efficiency investment to lower distribution service costs.

The Department should ensure that Distribution Company regulation will effectively persuade such companies to invest in both geographically targeted energy efficiency and distributed

clean generation where such investments will lower the cost of providing distribution services.

As the Department notes on page 41, energy efficiency investment may have an important role in minimizing distribution service costs, but substantial changes in how business is conducted at distribution companies will be necessary to capture these potential savings. Given the collective Massachusetts experience to date learning how difficult it was to plan and implement energy efficiency investment targeted primarily to avoid generation costs, we should anticipate the need for strong incentives and/or oversight to facilitate prompt and effective action by distribution companies in this area.

- Transmission energy efficiency investment.

CLF believes that investments in geographically targeted energy efficiency and clean distributed generation may be less expensive than certain future transmission system upgrades or than current means of providing certain services in support of transmission. While the Department is not directly responsible for ensuring that such "least cost" transmission investments are pursued in the future, CLF recommends that the Department include these concepts in its efforts to facilitate regional reform of transmission system and wholesale market operation.

V. Conclusion

____ In sum, CLF commends the Department for providing the right general direction towards a robust competitive generation market in its proposed rules, and for affirming the importance of

assuring environmental quality. With the suggestions set forth in these comments, the Department's final rules should provide for a quick transition to fair and robust generation competition and eliminate opportunities for continued protection of existing generation. Moreover, by assuring environmental comparability of existing plants, as set forth above, and providing for continued end use efficiency and commercialization of renewable resources in its final rules, the Department will, as required by MEPA, minimize any potential short to mid term adverse impacts from restructuring. The result should be substantial economic and environmental gains for the Commonwealth.

Respectfully submitted,

Armond Cohen, Senior Attorney
Jeanne Solé, Staff Attorney
Joseph Chaisson, Policy Director
Energy Project
Conservation Law Foundation
62 Summer Street
Boston, MA 02110
(617) 350-0990

Dated: May 24, 1996